

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 02-0274

Income Tax

For Tax Years 1995-97

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Gross Income—Royalty Income

Authority: Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977); Hoosier Energy Rural Electric Cooperative, Inc. v. Indiana Department of State Revenue, 572 N.E.2d 481 (Ind. 1991); IC 6-2.1-3-3; 45 IAC 1-1-51; Aug. 6, 1982, U.S.-Austl. art. 12, paras. 1,2,3, T.I.A.S. 10773

Taxpayer protests imposition of gross income tax on royalties.

II. Adjusted Gross Income—Business/Nonbusiness Income

Authority: The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001); 45 IAC 3.1-1-29; 45 IAC 3.1-1-30

Taxpayer protests the characterization of income as business income and the imposition of adjusted gross income tax on that income.

III. Adjusted Gross Income—Net Operating Loss

Authority: IC 6-3-2-2; IC 6-3-2-2.6

Taxpayer protests an adjustment to net operating loss calculations.

IV. Tax Administration—Negligence Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer operates a multi-national business in the metal industry. The business is vertically integrated throughout the metal products industry. As the result of an audit, the Indiana Department of Revenue (“Department”) issued proposed assessments for income tax for tax years 1996 and 1997, and a proposed refund for tax year 1995. Taxpayer protests some of these assessments as well as the refund. Further facts will be provided as required.

I. Gross Income—Royalty Income

DISCUSSION

Taxpayer protests the Department’s assessment of gross income tax on royalty income taxpayer received from the licensing of patented closure systems owned by an Indiana domiciled subsidiary. Some of the licensees are located in other states, while some are located in foreign countries. In the audit report, the Department referred to 45 IAC 1-1-51, which deals with the situs of intangibles and states in relevant part:

The Department applies two tests in determining the taxability of income from intangibles. The term “intangible” or “intangible property” as used in IC 6-2-1-1(m) [*Repealed by P.L. 77-1981, SECTION 22.*], means and includes notes, stocks in either foreign or domestic corporations, bonds, debentures, certificates of deposit, accounts receivable, brokerage and trading accounts, bills of sale, conditional sales contracts, chattel mortgages, “trading stamps,” final judgments, leases, royalties, certificates of sale, choses in action and any and all other evidences of similar rights capable of being transferred, acquired or sold.

The first test is what may be termed the “business situs” of the taxpayer or the relationship of the income from the tangible to the business activity of the taxpayer in Indiana. If the intangible or the income derived therefrom forms an integral part of a business regularly conducted at a situs in Indiana, the total gross income derived from the sale, assignment, transfer or exchange of the rights comprising the intangible property, or from the transfer of ownership to another will be required to be reported for taxation under IC 6-2-1-1(m) [*Repealed by P.L. 77-1981, SECTION 22.*] at the higher rate under IC 6-2-1-3(g) [*Repealed by P.L. 77-1981, SECTION 22.*] The test of a “situs” has been defined in Regulation 6-2-1-1(m)(330) [*45 IAC 1-1-49*] and out-of-state business is discussed in Regulation 6-2-1-1(m)(340) [*45 IAC 1-1-50*]).

Therefore, if a taxpayer has a “business situs” in Indiana, as defined by Regulation 6-2-1-1(m)(330) [*45 IAC 1-1-49*]), and the intangible or the income derived therefrom is connected with that business, either actually or constructively, the gross receipts of those intangibles will be required to be reported for gross income purposes.

In addition to the case where the owner of the intangible is doing business in Indiana and the intangibles form an integral part of such owner's business conducted at or through his "business situs" in Indiana, a taxpayer may also be liable for gross income tax from intangibles if he is deemed to have established a "commercial domicile" in Indiana. Thus the second test is what may be termed the "commercial domicile" of the taxpayer.

A taxpayer may have many business situses, but has only one commercial domicile. Where that is located must be determined based on all of the facts. Generally speaking, a commercial domicile may be viewed as the location of the majority of all the taxpayer's activities or business. The commercial domicile may also be called the "nerve center" or "corporate center" of all the business functions of the taxpayer.

If a taxpayer's commercial domicile is in Indiana, all of the income from intangibles will be taxed under IC 6-2-1-1(m) [*Repealed by P.L. 77-1981, SECTION 22.*] except that income which may be directly related to an integral part of a business regularly conducted at a "business situs" outside Indiana.

...

The taxability of royalty income from such sources as patents or copyrights is to be determined as other income from intangibles according to the tests outlined previously on the "business situs" of the taxpayer or the "commercial domicile" of the taxpayer.

Examples of transactions in intangibles which are partially or wholly excluded from taxation are:

...

Sales which are totally nontaxable as transactions in interstate commerce

....

Taxpayer protests that the assessment of gross income violates several aspects of the United States Constitution, including the Commerce Clause, the Due Process Clause, the Foreign Commerce Clause, the Import-Export Clause and the Equal Protection Clause. Taxpayer refers to IC 6-2.1-3-3, which states:

Gross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that income by the United States Constitution.

The Indiana Supreme Court has previously dealt with the interstate sale of intangibles and gross income tax consequences. In Hoosier Energy Rural Electric Cooperative, Inc. v. Indiana Department of State Revenue, 572 N.E.2d 481 (Ind. 1991), the Indiana domiciled and sitused taxpayer had sold its rights to claim certain federal income tax benefits to two out-of-state companies via New York investment bankers. The Department assessed gross income tax on the income from the sale of the rights to the federal tax benefits. The taxpayer protested that there

was insufficient nexus to Indiana, that the tax was not fairly apportioned, that the tax discriminated against interstate commerce in favor of local commerce and that the tax was not fairly related to the services provided by Indiana. The court explained:

The intangible which was sold, federal income tax benefits, cannot exist separate and apart from the taxpayer and property which, with the aid of *IRC § 168(f)*, created the intangible. Therefore, the taxation of this sale complies with the first prong of the Complete Auto test.
Id., at 485.

Similarly, in the instant case, the rights to taxpayer's patents were licensed to the out-of-state licensees, but the intangible cannot exist apart from the Indiana domiciled and situated subsidiary. There is sufficient nexus to Indiana to justify the assessment of gross income tax.

Next, regarding fair apportionment of the tax, the court explains:

A tax by New York does not present a substantial or real risk of taxation in a constitutional sense. A tax by New York would not pass two of the Complete Auto tests. First, a New York tax on this sale of an intangible with a business situs in Indiana would not be fairly related to services provided by New York. Secondly, New York does not have sufficient nexus to the creation of the intangible to be able to tax its sale. Hoosier has not proven that this sale is exposed to any substantial risk of being taxed by New York or any other state. Therefore, we hold that the evidence supports the conclusion that the imposition of the tax at issue meets the apportionment requirement of Complete Auto.
Id., at 485.

In the instant case, a tax by another jurisdiction on the licensing of this intangible would not pass two of the Complete Auto tests. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). Taxpayer's business situs is Indiana and a tax by another jurisdiction would not be fairly related to services provided by the other jurisdiction. As in Hoosier Energy, in this case no other jurisdiction has sufficient nexus to the creation of the intangible to be able to tax its sale.

Next, regarding possible discrimination against interstate commerce, the court in Hoosier Energy explained:

The state gross income tax does not discriminate against interstate commerce in favor of local commerce. As the Tax Court correctly found, there is nothing in the operation of the tax that places a greater burden on out-of-state taxpayers than is placed on in-state taxpayers.

Taxpayer refers to Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (hereafter "Convention"), Article 12, which states in relevant part:

- (1) Royalties from sources in one of the Contracting States, being royalties to which a resident of the other Contracting State is beneficially entitled, may be taxed in that other State.
- (2) Such royalties may be taxed in the Contracting State in which they have their source, and according to the law of that State, but the tax so charged shall not exceed 10 percent of the gross amount of the royalties.
- (3) Paragraph (2) shall not apply if the person beneficially entitled to the royalties, being a resident of one of the Contracting States, has a permanent establishment in the other Contracting State or performs independent personal services in that other State from a fixed base situated therein, and the property or rights giving rise to the royalties are effectively connected with such permanent establishment or fixed base. In such case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

....

Aug. 6, 1982, U.S.-Austl. art. 12, paras. 1,2,3, T.I.A.S. 10773

Taxpayer believes that this is evidence that, since a foreign jurisdiction may impose withholding taxes on royalties paid to the licensor outside that jurisdiction, the royalties are subject to tax both within and outside the United States. Taxpayer asserts that this situation results in the net tax imposed on foreign royalties being higher than the tax imposed on domestic royalties, resulting in discrimination against foreign commerce. As previously explained, the sources of the royalties are not in the other states or nations, but rather the source is the patents held in Indiana where taxpayer's subsidiary has a business situs and the intangible property sold via the licensing agreements forms an integral part of taxpayer's subsidiary's business activities in Indiana.

Next, addressing the issue of whether or not the tax fairly related to the services provided by the State, the court in Hoosier Energy explained:

Obviously, citizens of the State of Indiana are expected to contribute their fair share of the state tax burden which pays for the multitude of services provided to the citizens by the State. There was no evidence presented to the Tax Court which would in any way show that this tax is not fairly related to the services provided by the State. Therefore, this tax on this sale passes the fourth part of the Complete Auto test.

As previously explained, taxpayer's subsidiary has its business situs in Indiana, is commercially domiciled in Indiana, holds the patents in Indiana, and the licensing agreements subject themselves to Indiana law. The tax is fairly related to the services provided by the State.

In conclusion, the licensing agreements were the sale of intangibles as provided in 45 IAC 1-1-51. The Indiana Supreme Court has addressed the situation of income received from the sale of intangibles by an Indiana situated and domiciled taxpayer. As explained in Hoosier Energy, since taxpayer's subsidiary is domiciled and situated in Indiana there is no risk of multiple taxation in this case since taxes imposed by other jurisdictions would not pass the four-part test provided in

Complete Auto. Here, there is sufficient nexus with Indiana, the tax is fairly apportioned, the tax does not discriminate against interstate commerce, and the tax is fairly related to services provided by the State.

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income—Business/Nonbusiness Income

DISCUSSION

Taxpayer protests imposition of adjusted gross income tax on income it received from the sale of interests it held in three businesses. The sale was part of a restructuring of taxpayer's business. Taxpayer reported the income on its federal return but considered it nonbusiness income and allocated the income to its commercial domicile, the state of Pennsylvania. The Department reclassified the income as business income and imposed adjusted gross income tax according to the apportionment formula. Taxpayer protests the reclassification.

The Department explained that, while there was no Indiana relationship of any of the entities that were sold and all property was located in foreign countries, taxpayer formed the entities and sold them three days later. Also, taxpayer included the entities in taxpayer's consolidated federal filing group. The Department expressed that clearly the intent of the formation of the entities was to sell them. Since the entities were formed to sell the foreign interests, the Department considered the income from the sales to be business income.

In The May Department Store Company v. Indiana Department of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001), the Indiana Tax Court determined that IC 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. Id. at 662-3.

The court looks to 45 IAC 3.1-1-29 and 30 for guidance in determining whether income is business or business income under the transactional test. These regulations state "... the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business." Id. at 664. 45 IAC 3.1-1-30 lists several factors in making this determination. These include the nature of the taxpayer's trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer's purpose in acquiring and holding the property producing income. In May, the Court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was not in the business of selling entire divisions. Id. at 664.

In the instant case, taxpayer held interests in the three foreign companies and transferred those interests to subsidiary corporations formed for the purpose of holding the interests. Three days

later, the newly formed subsidiary corporations sold most of the interests to non-related third parties. The Department considered the three-day ownership indicative of taxpayer's intention to form the companies for the sole purpose of selling them. The Department considered the intent to sell the interests to be business activity.

The court in May, explained that the transactional test requires the identification of the transactions and activity which are the elements of a particular trade or business. Id., at 644. In this case the transactions were the sale of interests in foreign mining operations. Taxpayer has provided sufficient documentation to establish that the mining operations were not part of taxpayer's world-wide metal products operations. One example among many provided is the establishment that the ores mined at the various foreign sites were sold primarily to non-related parties, and the amounts of ore which were bought by taxpayer were paid for at fair market prices. While this alone is insufficient to make taxpayer's case, the extensive documentation provided establishes that such arms-length interactions were standard procedure between taxpayer and the foreign operations.

Taxpayer was in the business of producing metals and metal products. These are the elements of taxpayer's particular trade or business. Taxpayer sold the interests in arms-length foreign mining operations to non-related parties. This is the transaction at issue. Taxpayer here was in the business of producing and selling metal and metal products, not the business of selling ownership of arms-length interests. As provided in May, this does not pass the transactional test.

The functional test focuses on the property being disposed of by the taxpayer. Id. at 664. Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. at 664. In order to satisfy the functional test the property generating income must have been acquired, managed and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. at 664. The court in May defined "integral" as part or constituent component necessary or essential to complete the whole. Id. at 664-5. The court held that May's sale of one of its retailing division was not "necessary or essential" to May's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not May. In essence, the court determined that because May was forced to sale the division in order to reduce its competitive advantage, the sale could not be integral to May's business operations. Therefore, the proceeds from the sale were not business income under the functional test.

As previously explained, in this case taxpayer has provided sufficient documentation to establish that it had arms-length relations with the foreign mining operations. The sales of the interests were neither necessary nor essential to complete the whole of taxpayer's whole business. While taxpayer was not forced to sell the interests, as was the case in May, the sales were not integral to taxpayer's operations. Since the sales and purchases of the metals and ores between the foreign interests and taxpayer were conducted at arms-length, taxpayer was not able to integrate the interests into its operations. Indeed, the foreign interests sold the bulk of their goods to non-related parties, which alone would make integration into taxpayer's operations unlikely. Therefore, as provided in May, the sales of the interests do not pass the functional test.

Regarding the Department's concerns that taxpayer formed corporations for the specific purpose of selling the interests, in some circumstances this is a strong indication of business-related activity. However, intention to sell is not an absolute characterization of business income. In May the taxpayer intended to sell its property, yet the Court determined via the transactional test and the functional test that the income was nonbusiness in nature. In the instant case, application of the transactional test and the functional test shows that the income was nonbusiness in nature.

In conclusion, taxpayer has provided extensive and convincing documentation that the foreign interests were not integral components of its business. The sales of the interests were intentional, but this is not the sole determining factor. Under both the transactional test and the functional test, the income from the sales in this case are nonbusiness income and should be allocated to taxpayer's commercial domicile, not apportioned partially to Indiana.

FINDING

Taxpayer's protest is sustained.

III. Adjusted Gross Income—Net Operating Loss

DISCUSSION

Taxpayer protests the reduction of claimed net operating loss via the Department's add back of nonbusiness income and foreign dividends to taxpayer's Indiana adjusted gross income. Taxpayer states that there is no statutory basis for this adjustment. Also, pursuant to a settlement agreement between taxpayer and the Department covering the previous audit period, the amount of net operating loss was increased by several million dollars. Taxpayer wants this increase reflected in the net operating loss credited to it in the instant audit period.

The Department explained its actions in the audit report, which states that for CY 1993, taxpayer incurred a net operating loss. Part of this loss was carried back to CY 1990 in the prior audit. During the instant audit period, the balance of the loss was carried forward to CY 1995 where it was fully utilized. The calculation of the net operating loss for CY 1993 was calculated by including the IND AGI determined per the prior audit. Next all nonbusiness and foreign dividend income was added back. Then the RAR adjustment received for this year was included. This total was then multiplied by the apportionment percentage also determined in the prior audit. For CY 1996, taxpayer incurred a net operating loss. This loss was carried to CY 1995 where it too was fully utilized.

The relevant statute is IC 6-3-2-2.6, which deals with corporate net operating loss and adjusted gross income. IC 6-3-2-2.6 states:

- (a) This section applies to a corporation or a nonresident person, for a particular tax year, if the taxpayer's adjusted gross income for that taxable year is reduced because of a deduction allowed under Section 172 of the Internal Revenue Code for a net operating loss. For purposes of section 1 of this chapter, the taxpayer's adjusted gross income, for the particular taxable year,

derived from sources within Indiana is the remainder determined under STEP FOUR of the following formula:

STEP ONE: Determine, in the manner prescribed in section 2 of this chapter, the taxpayer's adjusted gross income, for the taxable year, derived from sources within Indiana, as calculated without the deduction for net operating losses provided by Section 172 of the Internal Revenue Code.

STEP TWO: Determine, in the manner prescribed in subsection (b), the amount of the taxpayer's net operating losses that are deductible for the taxable year under Section 172 of the Internal Revenue Code, as adjusted to reflect the modifications required by IC 6-3-1-3.5, and that are derived from sources within Indiana.

STEP THREE: Enter the larger of zero (0) or the amount determined under STEP TWO.

STEP FOUR: Subtract the amount entered under STEP THREE from the amount determined under STEP ONE.

- (b) For purposes of STEP TWO of subsection (a), the modifications that are to be applied are those modifications required under IC 6-3-1-3.5 for the same taxable year during which each net operating loss was incurred. In addition, for purposes of STEP TWO of subsection (a), the amount of a taxpayer's net operating losses that are derived from sources within Indiana shall be determined in the same manner that the amount of the taxpayer's income derived from sources within Indiana is determined, under section 2 of this chapter, for the same taxable year during which each loss was incurred. Also, for purposes of STEP TWO of subsection (a), the following procedures apply:

- (1) The taxpayer's net operating loss for a particular taxable year shall be treated as a positive number.
- (2) A modification that is to be added to federal adjusted gross income or federal taxable income under IC 6-3-1-3.5 shall be treated as a negative number.
- (3) A modification that is to be subtracted from federal adjusted gross income or federal taxable income under IC 6-3-1-3.5 shall be treated as a positive number.

Taxpayer believes that Indiana cannot add back the nonbusiness income and foreign dividends under IC 6-3-2-2.6. Taxpayer states that nonbusiness income is allocated to its commercial domicile, not apportioned to Indiana. Taxpayer also states that Indiana is prohibited from taxing income of a foreign corporation under the apportionment procedures of IC 6-3-2-2(o).

Indiana is not taxing the nonbusiness income or the foreign dividends. These are deductions and exemptions which receive full credit where appropriate. In this case, Indiana has simply added those factors back in order to properly calculate a new deduction. Taxpayer's approach would result in compounding deductions and exemptions upon one another. Taxpayer has not referenced any statute or regulation which requires the Department to do so. The amount of NOL will be increased as agreed to in the settlement agreement covering the prior audit period.

FINDING

Taxpayer's protest is denied regarding the method of calculating net operating loss and sustained regarding the increased amount of net operating loss as agreed to in the previous settlement agreement.

IV. Tax Administration—Negligence Penalty

DISCUSSION

The Department issued proposed assessments and the ten percent (10%) negligence penalty for the tax years in question. Taxpayer protests the imposition of penalty. The Department refers to IC 6-8.1-10-2.1(a), which states in relevant part:

If a person:

...

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

...

the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC 6-8.1-10-2.1(a).

Taxpayer has not established that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is denied.

WL/JM 052809